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Public Financial Policy and the Problem of Inflation

(On August 3, 1980 Mr. G. E. Freeman, a Deputy Governor of the Bank of Canada, spoke at the 49th Annual Couchiching Conference, the topic of which was entitled "Living with Inflation". In the course of his comments on a paper delivered by Mr. J. L. Biddell, Mr. Freeman expressed some views of more general interest on public financial policy and the problem of inflation. The following is an extract of the relevant portion of Mr. Freeman's remarks.)

The main question about the 1980's that both Mr. Biddell and I are interested in is what can be done to halt and reverse the drift into increasingly severe inflation that seems to have been gathering momentum in Canada over a period of many years.

I work at the nation's central bank, the agency whose job involves trying to keep the quantity of money in Canada growing within limits high enough to meet the needs of a growing economy but not so high as to accommodate a continuation of rapid inflation. I am very much aware, therefore, that whatever else is done to tackle Canada's inflation problem, along the lines suggested by Mr. Biddell or in other ways, we at the Bank of Canada are still going to have our difficult job to do, year in and year out, to the best of our ability. The same goes, of course, for the various levels of government, both in terms of their broad responsibility for deciding how much they should spend, tax and borrow and in terms of their more narrowly focused policies, programs, and regulations that can have desirable or undesirable effects on inflation and growth.

Mr. Biddell's basic position, if I understand him correctly, is that we are in danger of relying too heavily on monetary and fiscal restraint in our efforts to turn the inflationary process around, to the exclusion of other initiatives that he believes offer the advantage of attacking the problem more directly, more effectively, and with fewer adverse side-effects on growth and employment.

...Now if that is a fair summary of Mr. Biddell's position, I doubt that there is any irreconcilable difference of opinion between us on matters of principle. I am the last person to rule out, for example, the potential usefulness of some form of temporary resort to incomes policies as a supplement to monetary and fiscal restraint in any and all circumstances. I was directly involved in an effort of this kind in 1969-70, and indirectly involved in preparatory work for the AIB program a few years later. Like Mr. Biddell, I am keenly aware of how difficult it is for a group of bureaucrats and ministers in Ottawa to design such a far-reaching system of government intervention in the economy in a way that meets even minimum standards of fairness and effectiveness, while avoiding all sorts of unforeseen but very perverse and undesirable effects on economic behaviour and efficiency. With all their drawbacks, however, programs of this kind seem likely to me to continue to be regarded by governments as the lesser of evils in circumstances where the struggle against rising inflation has become sufficiently desperate. For that reason I think we should welcome the attempt by as experienced a controller as Mr. Biddell to come up with some practical suggestions for reducing the problems created by programs of this kind and for increasing their effectiveness.

... Of course it is a lot easier to reach an accommodation of views on broad objectives than it is on the particular means to be employed in pursuing them. I must confess that I am from Missouri with respect to many of the specifics of Mr. Biddell's proposals.

... No doubt we could debate the details of Mr. Biddell's suggested program for hours, but these are essentially side issues and I have only a few minutes. The central issue raised by Mr. Biddell is the important one. Granted that we really have no choice but to do whatever turns out to be necessary to reverse the drift into increasingly severe inflation, what is the wisest way to proceed? What role, if any, should be played by monetary and fiscal restraint? Could other, more direct measures be used instead of monetary and fiscal restraint that would check inflation at least as effectively, but at lower cost in terms of growth and employment? Or is the best hope to rely on some combination of these various measures? Is there much chance that a gradual approach to overcoming our inflation problem will work? And if we don't manage to make it work, what alternatives are we left with?

In order to address these basic issues, I think we have to start from some view about why it is that the general level of prices in countries like Canada has risen the way it has over the past 25 years or so. Never before in our previous history have we experienced such a prolonged period of continuous and increasingly severe inflation. Between confederation and the late 1940's there were certainly episodes of steeply rising prices in Canada,

mainly during export-led booms in economic activity generated by major wars in the outside world. But there were also prolonged periods of slower economic growth and gradually declining prices, as well as the great depression of the 1930's. That is why it never would have occurred to my father or to your father, a generation ago, that prices and rates of pay would be much higher when they retired than when they first entered the work force. It is also why they felt confident that the money they set aside for their retirement savings and life insurance was real money -- not some flabby kind of money whose purchasing power was likely to shrink drastically over time at rates impossible to predict even a few years into the future.

All that has now gone by the board in the space of a single generation. Canadian's have apparently concluded from bitter experience that prices have nowhere to go but up, that as far ahead as one can see tomorrow's inflation is likely to be still more rapid than today's, and that it would be foolish to put much trust in the future value of our money here in Canada. This strongly-held expectation that inflation can only go from bad to worse seems to rest on a conviction that no democratic government will -- or perhaps even can -- do what is necessary to halt or reverse the process more than very briefly. This expectation has now become firmly embedded both in individual behaviour and in the way institutions function throughout our society.

Of course Canada isn't the only country that has fallen into the grip of continuous, worsening inflation. There are a number of countries where

the disease has reached a considerably more advanced stage than it yet has in Canada. They are worth visiting for a first-hand look at what a sea of troubles we in Canada may be heading for. But there are also several countries that seem to have resisted falling into escalating inflation rather successfully. And the odd thing is that their relatively successful efforts in resisting escalating inflation haven't necessarily saddled them with a stagnant economy: on the contrary, many of them seem to have achieved a better record of solid economic growth over the years than we have.

What has caused countries like Canada to contract the disease of chronic, accelerating inflation since the end of World War II? In an economy operating at normal levels of capacity utilization -- that is, with a normal margin of spare plant capacity and qualified manpower available for employment -- producers who try to set too high a price for their products run the risk of being undercut by their competitors, who can readily expand their production and take over a larger share of the market. Even a producer who is largely protected from competition has to worry about setting his prices so high that his volume of sales and output contracts to the point where his profits decline. Thus in a normally functioning economy there are market forces operating that put an upper limit on the prices it will pay firms to charge their customers. Increased upward pressure on particular parts of the price structure can of course develop at times from a variety of sources. Familiar examples include major crop failures, OPEC oil embargoes, and outbreaks of inflation abroad or sharp declines in the foreign exchange value of the currency that

push up a country's foreign trade prices. For a while this may mean that the whole price level rises faster. Provided, however, that public and private spending in the economy is not allowed to speed up correspondingly, market forces will over time correct this situation by making it increasingly difficult to increase prices to the same degree in other areas of the over-all price structure. Why, then, has persistently worsening inflation become such a problem? What has happened that has tended to weaken or suppress the normal role of market forces in keeping a lid on the price level?

The basic reason for this phenomenon, in my view, lies in the way that fiscal and monetary policies have tended to be conducted in countries like Canada since it became widely known how these policies could be used to help bring a country out of a severe depression such as that of the 1930's. In order to stimulate economic activity in circumstances of this kind, the policy combination recommended by Lord Keynes and his followers envisaged temporary resort to deficit spending by the government together with central bank action to keep interest rates from rising in consequence -- action that would temporarily involve a rapid increase in the quantity of money. This important and useful discovery implied that in extreme circumstances it was quite justifiable for governments to incur large deficits and for central banks to permit more rapid monetary expansion-- provided that these policies were promptly and fully reversed as and when these circumstances changed.

The first and more popular part of this policy prescription has been invoked repeatedly in Canada in recent decades, for a time with remarkable success, not to extricate the economy from any major depression but simply whenever the pace of economic activity has begun to falter. The second and less popular part of the prescription has been invoked only fitfully and with great reluctance, so that the necessary shift towards greater moderation in the degree of fiscal and monetary stimulus as renewed expansion turned into impending boom has generally been a case of too little and too late. When undertaken at last, on most occasions the effort to keep the degree of stimulus to spending within moderate bounds has soon been abandoned in the face of slowing growth and rising unemployment -- before it could have much lasting effect in moderating the size of price and cost increases. Thus we have had repeated over-heating of the economy interspersed with relatively brief and mild recessions, and this has had the effect of greatly reducing the market risks incurred by firms in raising their prices aggressively and letting their costs of production escalate.

If the worsening trend of inflation is to be halted (let alone reversed), it seems to me absolutely essential that this bias in the way monetary and fiscal policies have been conducted in the past must change -- as I think it has already begun to change in Canada and other developed countries. For some time now central banks have begun setting and trying to observe notional limits on how rapidly the process of monetary expansion should be allowed to move ahead, while governments have begun to set self-imposed limits on the growth of

their spending or deficits. Everyone connected with these policies is aware of the fact that with expectations of continuing rapid inflation now so firmly entrenched, the process of inflation has acquired too much momentum to be reversed at all quickly without risking a major economic crisis. That is why the approach being followed is a gradual and moderate one, the object of which is simply to be quite a bit more careful and consistent in trying to avoid over-stimulating the economy over the years to come than in the past.

There are a number of things that can be said about this attempt to move gradually over time towards a greater degree of continuing discipline in the nation's financial management. It wouldn't necessarily preclude resort to supplementary measures of a more direct character such as those Mr. Biddell has in mind, provided we could be reasonably confident that they would do enough lasting good to justify their many harmful and perhaps unavoidable side-effects, and provided that we did not use them as a substitute for responsible financial management. Any system of wage and price controls would soon fall apart unless it was reinforced by an adequate degree of fiscal and monetary restraint. Even a gradual approach to curing inflation will be far from painless. One can only hope that more Canadians will come to recognize that our economic prospects can only continue to worsen during the 1980's unless we as a nation can arrive at a more realistic view about what rates of economic growth and levels of employment are in fact compatible with gradually receding inflation. Moreover, Canadians need to be aware that eventual success in bringing chronic inflation to an end would not by itself be enough to restore the healthy functioning of the

Canadian economy. The achievement of greater productivity growth, a wider range of job opportunities, a stronger foreign trade performance and so on will necessarily require changes in many other areas of economic policy as well. Finally, a gradual approach to overcoming inflation will also demand a great deal of patience, because even on the best of assumptions the inflation rate will inevitably continue to bob up and down in the short run and it will take time for any gradual improvement in its underlying trend to become generally apparent.

What if the skeptics are right and that a policy of gradualism for dealing with our inflation problem not only turns out to be painful but can't be made to work? In that case, it's hard to see what alternatives we would have left that would not involve even stricter monetary and fiscal restraint, perhaps with even greater regimentation of our economic life.